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MEMORANDUM

TO: Docket Control
Arizona Corporation Commission

FROM: Ernest Johnson EG
Director
Utilities Division

DATE: November 6, 2006

RE: STAFF REPORT FOR GRAHAM COUNTY UTILITIES, INC.'S, APPLICATION FOR APPROVAL OF LONG-TERM DEBT (DOCKET NO. W-02527A-06-0505)

Attached is the Staff Report for Graham County Utilities, Inc.'s application for approval of long-term debt. Staff recommends conditional approval.

Any party to this procedure who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 16, 2006.

EGJ:CSB:tdp

Originator: Crystal S. Brown

Arizona Corporation Commission
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Service List for: Graham County Utilities
Docket No. W-02527A-06-0505

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

GRAHAM COUNTY UTILITIES, INC.
DOCKET NO. W-02527A-06-0505

APPLICATION
FOR APPROVAL
OF LONG-TERM DEBT

NOVEMBER 1, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Graham County Utilities, Inc., Docket Number W-02527A-06-0505, was the responsibility of the Staff members listed below. Crystal S. Brown was responsible for the financial review and analysis. Katrin Stukov was responsible for the engineering and technical analysis.

Crystal S. Brown

Crystal S. Brown
Public Utilities Analyst V

Katrin Stukov

Katrin Stukov
Utilities Engineer

EXECUTIVE SUMMARY
GRAHAM COUNTY UTILITIES, INC.
DOCKET NO. W-02527A-06-0505

Graham County Utilities, Inc. ("Graham") requests approval to issue $1,100,000 in long-term debt to the U. S. Department of Agriculture ("USDA") Rural Development.

The purpose of the long-term debt is to (1) finance the construction of water treatment projects to comply with the United States Environmental Protection Agency's drinking water standard for arsenic, (2) develop new water sources to meet the demand of the Cooperative's current customers and (3) refinance $130,547 in long-term debt.

Staff's analysis shows that a $1.1 million 40-year amortizing loan at 4.38 percent would result in a pro forma TIER of 1.27 and DSC of 1.18. These pro forma TIER and DSC indicate that Graham would have sufficient cash flow to meet all obligations. The resulting pro forma capital structure composed of 4.6 percent short-term debt, 91.7 percent long-term debt and 3.7 percent equity is excessively leveraged.

Staff recommends authorization for Graham to issue long-term debt to the USDA Rural Development in an amount not to exceed $1,100,000, subject to the condition that it adopts an equity accumulation plan as described in this report, to build equity to at least 30 percent of total capital.

Staff recommends that the Cooperative file a Curtailment Plan Tariff with Docket Control, as a compliance item in this docket, within 45 days after the effective date of the decision in this case for the review and certification of Staff. Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's website at www.cc.state.az.us/utility/forms/curtailment-std.pdf; Staff recognizes that the Cooperative may need to make minor modifications to the sample tariff according to their specific management, operational, and design requirements as necessary and appropriate.

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SCHEDULE

Attachment

Exhibit

Introduction and Background

On August 8, 2006, Graham County Utilities, Inc. ("Graham" or "Cooperative") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to issue debt to the United States Department of Agriculture ("USDA") Rural Development in an amount not to exceed $1,100,000 for its water division.

Graham is an Arizona Corporation and provides water and natural gas distribution service in small communities in and surrounding Thatcher, Safford and Pima in Graham County, Arizona. Graham's water division charges rates approved in Decision No. 61056 dated August 6, 1998. As of September 30, 2005, Graham provided service to approximately 6,000 customers: 1,100 water customers and 4,900 gas customers.

Public Notice

On August 8, 2006, the Cooperative filed an affidavit of publication verifying public notice of its financing application. The notification did not state the amount of the financing. Subsequently, on September 13, 2006, the Cooperative published a notice that stated the amount of the financing in the *Eastern Arizona Courier* a newspaper published in the City of Safford, Graham County. The affidavit of publication was filed on September 21, 2006.

Purpose and Terms of the Proposed Financing

The purpose of the long-term debt is to (1) finance the construction of water treatment projects to comply with the United States Environmental Protection Agency's ("USEPA") drinking water standard for arsenic, (2) develop new water sources to meet the demand of the Cooperative's current customers and (3) refinance $130,547 in long-term debt.

The proposed 40-year $1.1 million financing has an interest only payment due 12 months from the day of closing and is thereafter amortized at 4.375 percent per annum. Monthly payments for the 39-year amortization term of the loan would be approximately $5,000.

Engineering Analysis

Staff examined the construction plans and estimated costs for Graham's water treatment project and found them to be reasonable and appropriate as discussed in the attached Engineering Memorandum.

Staff recommends that the Cooperative file a Curtailment Plan Tariff with Docket Control, as a compliance item in this docket, within 45 days after the effective date of the decision in this case for the review and certification by Staff. Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's website at www.cc.state.az.us/utility/forms/curtailment-std.pdf; Staff recognizes that the Cooperative may need to make minor modifications to the sample tariff according to their specific management, operational, and design requirements as necessary and appropriate.

Financial Analysis

Staff's analysis is based on Graham's audited financial statements dated September 30, 2005. The financial analysis shown on Schedule CSB-1 presents selected financial information from the financial statements, the pro forma effect of the proposed $1.1 million loan and refunding of an existing $130,548 loan with the proceeds. Schedule CSB-1 also shows the capital structure and ratios for debt service coverage ("DSC") and times interest earned ("TIER").

Capital Structure

At September 30, 2005, Graham's capital structure consisted of 5.77 percent short-term debt, 89.36 percent long-term debt, and 4.87 percent equity. Graham drawing the entire proposed loan of $1,100,000 and refunding of an existing $130,548 loan with the proceeds would result in a pro forma capital structure comprised of 4.62 percent short-term debt, 91.65 percent long-term debt and 3.73 percent equity as shown on Schedule CSB-1.

Staff evaluates a number of factors (including access to capital, current level of debt, system age and condition, management experience, the adequacy of existing or proposed rates) to determine an appropriate capital structure for each utility. Typically, an appropriate capital structure for a cooperative would have at least 30 percent equity. Accordingly, the Cooperative's proposed loan would result in a capital structure that is more leveraged than preferable.

However, there are no better options for Graham to finance the construction of the arsenic removal plant. Non-compliance may result in delivery of unsafe water and other consequences that may have detrimental operational and financial impacts on the Cooperative and detrimental health consequences for its customers.

Due to Graham's highly leveraged capital structure, it would be appropriate for the Commission to condition any authorization for debt issuance on adoption of an equity accumulation plan. The following is a description of an appropriate plan.

1. First, establish a base members' equity position by using the Cooperative's total members' equity at September 30, 2005, of $154,258.

2. Second, establish an objective to increase members' equity over the base position by no less than two percent of all cumulative revenues recorded subsequent to September 30, 2005, as measured at the end of each fiscal year, until members' equity represents at least 30 percent of total capital; and thereafter, to maintain at a minimum members' equity at 30 percent of total equity.

3. Third, require filing of a rate application no later than June 30th of the year subsequent to any fiscal year in which the equity goal is not achieved. A waiver[1] for the current year only may be granted if Graham can demonstrate to Staff's satisfaction that it is likely to comply with the cumulative members' equity objective within 24 months without any rate adjustment. A rate filing should be filed by any and all division(s) whose net margin(s) is (are) less than two percent of operating revenue in the prior fiscal year.

4. Fourth, require filing of an annual report by April 15th with Docket Control as a Compliance item until such time that members' equity equals no less than 30 percent of total capital. Illustrative examples of the type and form of information to be filed are shown on Exhibit 1, pages 1 through 3. The report should include the following:
    a. Annual revenues for each fiscal year ending after September 30, 2005;
    b. Cumulative revenues recorded subsequent to September 30, 2005;
    c. The member's base equity position at September 30, 2005 (i.e., $154,258);
    d. The members' equity position at the end of each fiscal year after September 30, 2005; and
    e. A declaration of the Cooperative's compliance or non-compliance with the two percent equity growth requirement discussed in item no. 2.

Interest and Debt Service Coverage

Staff also examined the effects of the proposed financing on the Cooperative's TIER and DSC.

DSC represents the number of times internally generated cash (i.e., earnings before interest, income tax, depreciation and amortization expenses) covers required principle and interest payments on debt. A DSC greater than 1.0 means operating cash flow is sufficient to cover debt obligations.

TIER represents the number of times earnings before income tax expense covers interest expense on debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not necessarily mean that debt obligations cannot be met in the short term.

Based on the 2005 financial statements Graham's TIER and DSC without the proposed loan are 1.56 and 1.34, respectively. Fully drawing the proposed $1,100,000 loan and refunding

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[1] Waiver requests should be made by December 31st and memorialized with a memorandum to Docket Control noting the request. Support for a waiver request may be conveyed in any suitable form and include any relevant information; however, Graham should expect at a minimum to provide Staff with financial projections (with all critical assumptions identified) that demonstrate how the equity objective will be met. The waiver shall be denied unless Staff files a memorandum with Docket Control by March 1st accepting the waiver request. A waiver is applicable to the current year only and may not be granted in consecutive years.

of an existing $130,548 loan with the proceeds reduces the pro forma TIER and DSC to 1.27 and 1.18, respectively. The pro forma TIER and DSC show that Graham would have adequate cash flow to meet all obligations including the proposed debt.

Conclusions and Recommendations

Staff concludes that the project the Cooperative proposes to construct and the refinancing of the $130,547 in long-term debt is reasonable and appropriate.

Staff concludes that the proposed financing is within Graham's powers as a corporation, is compatible with the public interest and would not impair its ability to provide public service. It would also be consistent with sound financial practices if the Cooperative had a plan that is satisfactory to Staff to build equity to 30 percent of total capital.

Therefore, Staff recommends approval of the Cooperative's application for authority to issue debt to USDA Rural Development not to exceed $1,100,000 subject to the condition that it adopts the following equity accumulation plan:

1. First, establish a base members' equity position by using the Cooperative's total members' equity at September 30, 2005, of $154,258.

2. Second, establish an objective to increase members' equity over the base position by no less than two percent of all cumulative revenues recorded subsequent to September 30, 2005, as measured at the end of each fiscal year, until members' equity represents at least 30 percent of total capital; and thereafter, to maintain at a minimum members' equity at 30 percent of total equity.

3. Third, require filing of a rate application no later than June 30th of the year subsequent to any fiscal year in which the equity goal is not achieved. A waiver[2] may be granted if Graham can demonstrate to Staff's satisfaction that it is likely to comply with the cumulative members' equity objective within 24 months without any rate adjustment. A rate filing should be filed by any and all division(s) whose net margin(s) is (are) less than two percent of operating revenue in the prior fiscal year.

4. Fourth, require filing of an annual report by April 15th with Docket Control as a Compliance item until such time that members' equity equals at least 30 percent of

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[2] Waiver requests should be made by December 31st and memorialized with a memorandum to Docket Control noting the request. Support for a waiver request may be conveyed in any suitable form and include any relevant information; however, Graham should expect at a minimum to provide Staff with financial projections (with all critical assumptions identified) that demonstrate how the equity objective will be met. The waiver shall be denied unless Staff files a memorandum with Docket Control by March 1st accepting the waiver request. A waiver is applicable to the current year only and may not be granted in consecutive years.

total capital. Illustrative examples of the type and form of information to be filed are shown on Exhibit 1, pages 1 through 3. The report should include the following:

a. Annual revenues for each fiscal year ending after September 30, 2005;
b. Cumulative revenues recorded subsequent to September 30, 2005;
c. The base member's equity position at September 30, 2005 (i.e., $154,258);
d. The members' equity position at the end of each fiscal year after September 30, 2005; and
e. A declaration of the Cooperative's compliance or non-compliance with the two percent equity growth requirement discussed in item no. 2.

Staff further recommends authorizing Graham to engage in any transactions and to execute any documents necessary to effectuate the authorizations granted.

Staff further recommends that one copy of executed security documents be filed with Docket Control, as a Compliance item in this docket, within 60 days of the execution of any transactions.

Staff recommends that the Cooperative file a Curtailment Plan Tariff with Docket Control, as a compliance item in this docket, within 45 days after the effective date of the decision in this case for the review and certification of Staff. Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's website at www.cc.state.az.us/utility/forms/curtailment-std.pdf; Staff recognizes that the Cooperative may need to make minor modifications to the sample tariff according to their specific management, operational, and design requirements as necessary and appropriate.

Graham County Utilities, Inc.
Docket No. W-02527A-06-0505
Application For Financing

Schedule CSB-1

FINANCIAL ANALYSIS

Selected Financial Information

		[A] 9/30/2005		[B] Pro Forma [1]	
1	Oper. Inc. Before Int. Exp on L.T. Debt	$ 265,025		$ 265,025	
2	Depreciation & Amortization Expense	210,726		210,726	
3	Income Tax Expense	0		0	
4	Interest Expense on Debt	169,880		207,942	
5	Repayment of Principal	185,490		193,861	
	TIER				
6	[1+3] ÷ [4]	1.56		1.27	
	DSC				
7	[1+2+3] ÷ [4+5]	1.34		1.18	
8	Short-term Debt	$182,944	5.77%	$191,315	4.62%
9	Long-term Debt	$2,832,393	89.36%	$3,793,474	91.65%
10	Common Equity	$154,258	4.87%	$154,258	3.73%
11	Total Capital	$3,169,595	100.00%	$4,139,047	100.00%

[1] Pro Forma reflects a $1.1 million 39-year amortizing loan at 4.38 percent and refunding of an existing $130,548 loan.
Staff calculations:

	Interest Exp	Principal Repayment
Year Ended 9/30/05	$169,880	185,490
1.1 Million Loan	47,907.50	10,932.89
Refunded Loan	(9,846.00)	(2,562.00)
Pro Forma Amount	$207,942	$193,861

	Short-term Debt	Long-term Debt
Year Ended 9/30/05	$182,944	$2,832,393
1.1 Million Loan	10,932.89	1,089,067
Refunded Loan	(2,562.00)	(127,986.00)
Pro Forma Amount	$191,315	$3,793,474

MEMORANDUM

DATE: September 15, 2006

TO: Crystal S. Brown
Senior Rate Analyst

FROM: Katrin Stukov KS
Utilities Engineer

RE: Graham County Utilities, Inc.
Authority for Financing
Docket No. W-02527A-06-0505

Introduction

Graham County Utilities, Inc.-Water Division (the "Company") has submitted a financing application for improvements and additions to the Company's utility plant which provides water supply to approximately 1,000 customers in the area of Pima just west of Safford in Graham County Arizona. Currently, the Company is experiencing difficulty in meeting water demand and the new Environmental Protection Agency arsenic standard of 10 ppb.

Construction Project and Cost

As part of a technical assistance, the Company hired an engineering firm, Fluid Solutions (the "Firm"), to perform a study to analyze the conditions and alternative solutions to resolve water quantity and quality issues. As the most cost effective solution, the Firm's report recommends a blending plan which includes the addition of six new wells, a pilot well and a 500,000 gallon water storage tank. The Firm developed a cost estimate for the recommended additional infrastructure. The total estimated 2005 cost for the recommended wells and storage tank additions was $1,951,620, which includes a 10% contingency fee and future engineering costs.

Arizona Department of Environmental Quality ("ADEQ") Compliance

ADEQ regulates the water systems operated by the Company. ADEQ reported on August 21, 2006 that the systems are currently in compliance with ADEQ requirements and delivering water that meets water quality standards required by Arizona Administrative Code, Title 18, Chapter 4.

Arizona Corporation Commission ("ACC") Compliance Status

A check with the Utilities Division Compliance Section showed no outstanding compliance issues for the Company.

Curtailment Tariff

A Curtailment Plan Tariff ("CPT") is an effective tool to allow a water company to manage its resources during periods of shortages due to pump breakdowns, droughts, or other unforeseeable events. Since the Company currently does not yet have a CPT, this Finance Application provides an opportune time to prepare and file a CPT.

Conclusions and Recommendations

The project and estimated costs appear to be reasonable and appropriate. However, approval of this financing application does not imply any particular future treatment for rate base. No "used and useful" determination of the proposed plant was made, and no conclusions should be inferred for rate making or rate base purposes.

Staff recommends that the Company file a CPT with Docket Control, as a compliance item in this same docket, within 45 days after the effective date of the decision in this case for the review and certification of Staff. Staff further recommends that the tariff shall generally conform to the sample tariff found on the Commission's website at www.cc.state.az.us/utility/forms/curtailment-std.pdf;. Staff recognizes that the Company may need to make minor modifications to the sample tariff according to their specific management, operational, and design requirements as necessary and appropriate.

Illustrative Example of a 2007 Equity Accumulation Report Annual Filing

Graham County Utilities, Inc.
Combined Water and Gas Divisions
2007 Annual Equity Accumulation Report
Decision No. _______

Line Nos.	Years	For the Fiscal Year Ended September 30th	
1		Annual Revenues	Cumulative Revenues
2	2006	$3,755,000	$3,755,000
3			
4			
5			

Line Nos.	Years	For the Fiscal Year Ended September 30th	
6		Equity Balance as of 9/30/05	Annual Equity Balances
7	2005	$154,258 (Base Period)	
8	2006		$150,000[1]
9			
10			

Compliance Analysis		
Line Nos.	Calculation of 2% Equity Goal Requirement	
11	2006 Equity Balance	$150,000
12	Less Base Period Balance	- $154,258
13	Actual Increase in Equity	<$ 4,258>
14		
15	2006 Cumulative Revenue	$3,755,000
16	Multiplied by	x .02
17	Two Percent Equity Goal	$ 75,100
18	If **Line 13** is **greater than Line 17**, the 2% Equity Increase goal **has been met go to Line 22.**	
19	**If Line 13 is less than Line 17, write "Equity Increase Goal Not Achieved" in the space to the right. Go to Line 20.**	Equity Increase Goal Not Achieved.
20	If the Cooperative has been granted a waiver from filing a rate application, write "Waiver Granted and Attached" in the space to the right and attach the Staff memorandum granting approval and go to Line 22. Otherwise, go to Line 21.	Waiver Granted and Attached.
21	The Company is required to file a rate application by June 30th as a compliance item. If a rate application has been filed, write the Docket No. for the rate application in the space to the right. Otherwise, write "Rate Application Required by June 30th" in the space to the right. Go to Line 22.	
22	If Line 21 is "Rate Application Required by June 30th" write "Not in Compliance" in the space to the right. Otherwise, write "In Compliance". Go to Line 23.	In Compliance.
23	Is Members' Equity at least 30% of total equity? Write "Yes" or "No" in the space to the right. If "Yes", attach support; no further filings are required.	No

[1] Decrease in equity caused by $3,000 net loss in gas division and $1,258 net loss in water division.

Illustrative Example of a 2008 Equity Accumulation Report Annual Filing

Graham County Utilities, Inc.
Combined Water and Gas Divisions
2008 Annual Equity Accumulation Report
Decision No. _______

Line Nos.	Years	For the Fiscal Year Ended September 30th	
1		Annual Revenues	Cumulative Revenues
2	2006	$3,755,000	$3,755,000
3	2007	$3,800,000	$7,555,000
4			
5			

Line Nos.	Years	For the Fiscal Year Ended September 30th	
6		Equity Balance as of 9/30/05	Annual Equity Balances
7	2005	$154,258 (Base Period)	
8	2006		$150,000
9	2007		$240,000
10			

Compliance Analysis		
Line Nos.	Calculation of 2% Equity Goal Requirement	
11	2007 Equity Balance	$240,000
12	Less Base Period Balance	- $154,258
13	Actual Increase in Equity	$ 85,742
14		
15	2007 Cumulative Revenue	$7,555,000
16	Multiplied by	x .02
17	Two Percent Equity Goal	$ 151,100
18	If **Line 13** is **greater than Line 17**, the 2% Equity Increase goal **has been met. Go to Line 22.**	
19	If **Line 13** is **less than Line 17, write "Equity Increase Goal Not Achieved" in the space to the right. Go to Line 20.**	Equity Increase Goal Not Achieved.
20	If the Cooperative has been granted a waiver from filing a rate application, write "Waiver Granted and Attached" in the space to the right and attach the Staff memorandum granting approval and go to Line 22. Otherwise, go to Line 21.	
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22	If Line 21 is "Rate Application Required by June 30th" write "Not in Compliance" in the space to the right. Otherwise, write "In Compliance." Go to Line 23.	Not in Compliance.
23	Is Members' Equity at least 30% of total equity? Write "Yes" or "No" in the space to the right. If "Yes", attach support; no further filings are required.	No

Illustrative Example of a 2009 Equity Accumulation Report Annual Filing

Graham County Utilities, Inc.
Combined Water and Gas Divisions
2009 Annual Equity Accumulation Report
Decision No. _______

Line Nos.	Years	For the Fiscal Year Ended September 30th	
1		Annual Revenues	Cumulative Revenues
2	2006	$3,755,000	$ 3,755,000
3	2007	$3,800,000	$ 7,555,000
4	2008	$4,000,000	$11,555,000
5			

Line Nos.	Years	For the Fiscal Year Ended September 30th	
6		Equity Balance as of 9/30/05	Annual Equity Balances
7	2005	$154,258 (Base Period)	
8	2006		$150,000
9	2007		$240,000
10	2008		$390,000

Compliance Analysis		
Line Nos.	Calculation of 2% Equity Goal Requirement	
11	2008 Equity Balance	$390,000
12	Less Base Period Balance	- $154,258
13	Actual Increase in Equity	$ 235,742
14		
15	2008 Cumulative Revenue	$11,555,000
16	Multiplied by	x .02
17	Two Percent Equity Goal	$ 231,100
18	If **Line 13** is **greater than Line 17**, the 2% Equity Increase goal **has been met go to Line 22.**	
19	**If Line 13 is less than Line 17, write "Equity Increase Goal Not Achieved" in the space to the right. Go to Line 20.**	Equity Increase Goal Not Achieved.
20	If the Cooperative has been granted a waiver from filing a rate application, write "Waiver Granted and Attached" in the space to the right and attach the Staff memorandum granting approval and go to Line 22. Otherwise, go to Line 21.	
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22	If Line 21 is "Rate Application Required by June 30th" write "Not in Compliance" in the space to the right. Otherwise, write "In Compliance." Go to Line 23.	In Compliance.
23	Is Members' Equity at least 30% of total equity? Write "Yes" or "No" in the space to the right. If "Yes", attach support; no further filings are required.	No